No. 10214.

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IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

Todd W. Johnson,

Appellant,

vs.

United States of America,

Appellee.

APPELLANT'S REPLY BRIEF.

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Statement.

Briefs already filed by appellant and appellee set forth the law and facts involved herein but appellant wishes to point out two inadvertent erroneous statements of facts in appellee's brief, as follows:

On page 1 appellee states that appellant paid the tax in controversy in 1936, whereas he paid such tax on June 11, 1938. [R. 84.]

On page 5 appellee states that in the event taxpayer is successful in his contentions in this case, the refund should be limited to the difference or balance between the deficiency originally determined by the Commissioner and the overpayment determined in favor of appellant's wife which was credited to or against said deficiency. Actually appellant and the Commissioner agreed that any such refund or "recovery on the community property basis shall be limited to the net amount after giving effect to the resultant tax due from his wife and barred from assessment against her by the Statute of Limitations." [R. 85.] This would mean that any refund of tax to appellant would be reduced by the deficiency tax which his wife would owe on $17,892.20 additional income (not $26,-014.23) if appellant's contentions on pages 21 to 25, inclusive, of his opening brief are sustained.

ARGUMENT.

At the outset appellant wishes to emphasize that this is the first time the particular question involved herein has been presented to any Appellate Court and the decision of this Court will be of unusual significance.

In this reply brief appellant will follow the sequence of appellee's brief as nearly as possible in endeavoring to show the unsoundness of appellee's arguments.

Appellant's Ownership of His Wife's Half of the Community Fees at the Time He Collected Them Does Not Make Him Taxable Thereon.

1. Appellee first argues that, "as a general rule compensation for personal services is taxable to the one who earned it and controlled its disposition", but "an exception is made in the community property states in that the wife's technical ownership of a one-half interest in the husband's earnings makes that portion taxable to her". (Br. 7.)

Actually the general rule is that the person (or corporation) who *owns the right to receive such compensation for personal service at the time it is earned* is the one tax able thereon. There are two exceptions to this rule, and only two, of which appellant is aware, viz., first, if a person assigns his future earnings to another person, *without a full consideration in money or property*, the earner-assignor and not the assignee (owner of the income when earned) is taxable on the earnings when they are subsequently earned and collected (*Lucas v. Earl,* 281 U. S. 111; *Helvering v. Horst,* 311 U. S. 112; *Helvering v. Eubank,* 311 U. S. 122); *Somerville, Van Every* and *Van Dyke* cases, *infra,* and second, if a person assigns *past uncollected earnings* for a full consideration in money or property, the original owner-assignor is relieved from income tax on the income assigned when it is collected—*but in lieu thereof such original owner is taxable on the consideration received* in exchange or payment for the assigned income. *Helvering v. Smith,* 90 Fed. (2d) 590 (C. C. A. 2); *Doyle v. Com.,* 102 Fed. (2d) 86 (C. C. A. 4).

In numerous instances compensation for personal services is not earned by nor taxed to the person who actually performs the services. For instance one law partner may perform the services for which a certain fee is paid but he does not earn and is not taxable on the fee. The partnership earns the fee and he is taxable only on his partnership portion thereof. An officer or employee of a corporation may perform a service for which payment is made to the corporation, but the officer or employee does not earn and is not taxable on the payment to the corporation but instead he earns and is taxable on the salary he receives. Likewise, in a community property state, a spouse, who performs a service for which a legal fee is paid or payable to the marital community or partnership, does not earn and is not taxable on the fee. The marital partnership earns the fee and each spouse is taxable on half thereof as a member of the marital community.

Therefore, under the general rule and not as an exception thereto, the wife is taxable on one-half of the community income from the husband's services because she owns one-half thereof when the service is performed. *Poe v. Seaborn,* 282 U. S. 101.

When one spouse dies the entire marital community is administered upon and the executor *owns and is taxable on all of the income* during the administration and the surviving spouse owns and is taxable on no part thereof. (*Commissioner v. Larson,* decided by this Court on October 21, 1942.) The *Larson* case involved only income on community property (not income for personal services) and such income was *earned or accrued and collected* during the administration. Any earnings or income, which were either earned or accrued prior to the death of the deceased spouse, were taxable half to the decedent in his last income tax return and half to his wife, even though collected during the administration of the estate. *Helvering v. Enright,* 312 U. S. 636.

2. Appellee next argues that by agreement appellant and his wife could and did make both the future and past (but uncollected) earnings of appellant his separate property and, since appellant owned his wife's half of said past earnings when he collected them, he was taxable on his wife's half thereof as well as his own, because the exception to the general rule (taxing one-half to each spouse) no longer is applicable.

Appellant has already shown that the taxation of half the community income to each spouse is not an exception to but is the general rule, viz., income is taxable ultimately to the one who owns it at the time it is earned. It should be borne in mind that the "past earnings" were not his past earnings, but were the past earnings of the marital community or partnership, and were merely community property in which each spouse had a vested one-half interest. As the United States Supreme Court said in *Poe v. Seaborn, supra:*

> "The earnings (of the husband) are never the property of the husband, but that of the community." (Parenthetical clause supplied.)

If one law partner acquires for cash or property his law partner's half of a particular fee in a case on which his law partner had done no work, it cannot be correctly said that he received and collected his past earnings since the partnership, not he, earned the fee. Certainly the acquiring law partner could recover his cost of the share in the fee acquired from his partner before he received taxable income. *Smith* and *Doyle* cases, *supra.*

Of course appellant owned his wife's half of said past earnings when he collected them, but he acquired them in a capital transaction as will hereafter be pointed out. However, he did not own them as his "separate property" but as his "property". The term "separate property" is used to distinguish property owned by each spouse from that owned by the marital community. Since the community was dissolved by the agreement the fees or past earnings were simply his "property". This point is brought out to emphasize the fact that the husband and wife relationship has no bearing on this case. The matter should be considered the same as if any two unmarried persons who each owned half of certain property, including legal fees earned but not collected, make an agreement dividing it equally between themselves. This is so because the spouses can only make such contracts "which either might if unmarried". *California Civil Code*, Sec. 158.

As property appellant's wife could and did convey or surrender her half to appellant; he owned her half thereof and she did not when he collected said fees; but his ownership *at the time of collection* does not establish that he is taxable on her half of said fees. Ownership by the wife *at the time the marital partnership earned the income* makes her taxable either on her half itself when collected or, if she has surrendered or transferred her half for money or property, on the consideration received in lieu thereof. See also the following cases which held that the *owner of the income at the time it is earned* must pay the tax thereon when it is collected. *Albert Houston v. Commissioner of Internal Revenue,* 31 B. T. A. 188; *Delvin v. Commissioner,* 9th Circuit, 82 Fed. (2d) 731, 17 A. F. T. R. 690; *Asher v. Welch* (D. C. Cal.), 28 Fed. Supp. 893, 23 A. F. T. R. 664, affirmed 111 Fed. (2d) 59.

In the *Horst* and *Eubank* cases, *supra,* and *Van Meter v. Com.,* 61 Fed. (2d) 817, the donee or assignee of earned income was clearly the owner thereof when it was collected. Such income was the "separate" property of the wife or other donee, but the assignor or donee (original owner) was held taxable thereon. In the *Smith* case, *supra,* the continuing law partners (assignees for full consideration in money or property) were the owners of the assigned share of fees when the fees were collected but the retiring law partner was held taxable on the consideration received by him in exchange for said share.

If appellant's wife made a gift or a transfer, without a valuable consideration, of her half of said fees, she remains taxable on her half. *Horst* and *Eubank* cases, *supra.* If she received an adequate consideration therefor in money or property she is taxable on the consideration received but not on the fees when collected. *Smith* and *Doyle* cases, *supra.* Conversely appellant is entitled to deduct the consideration paid by him from her half of said fees before paying any income tax thereon. If appellant's wife did not transfer her half of the fees in question to appellant for a consideration in money or property (which she actually did) or as a gift, she must have transferred it to him in discharge or satisfaction of some marital obligation and is taxable on the market value of her half under the rule of *Commissioner v. Mesta,* C. C. A. 3, 123 F. (2d) 986. In that case Mesta had a small cost for the property transferred to his wife in satisfaction of her marital right to support and only the difference between the cost and market value of the property was taxable to him. Here the wife had no cost for her half of the fees and is taxable on the full market value thereof. (See pages 18-19 of this brief for further analysis of the *Mesta* case.)

3. The appellee next argues that the following cases decided by this Court are decisive of the present case: *Van Every v. Com.,* 108 F. (2d) 650; *Boland v. Com.,* 118 F. (2d) 622; *Van Dyke v. Com.,* 120 F. (2d) 945, and *Somerville v. Com.,* 123 F. (2d) 975.

The appellee frankly admits, as it must, that none of these cases involved *income earned before and collected after the agreement* (past earnings) but on the other hand each case involved *income both earned and collected by the husband after the marital partnership was* dissolved by agreement (future earnings). As pointed out on pages 14 to 18, inclusive, of appellant's opening brief these four cases merely hold that, when the community is dissolved by agreement each spouse is *emancipated* and the subsequent personal earnings of each former spouse are taxable in full to him or her because each spouse then owns the income he or she earns *at the very time it is earned.* This is exactly what happens when a law or business partnership is dissolved, *viz.*. each partner thereafter is taxable on his personal earnings, but the past earnings of the partnership are still taxable to the partners in accordance with their respective partnership interests and not according to who performed the service for which the payment is received. Furthermore, when one partner transfers his share of earned but uncollected fees to another partner, in settlement or dissolution of the partnership, the transferring partner is taxable on the consideration he receives and the acquiring partner is only taxable on the difference, if any, between the amount paid therefor and the amount collected therefrom. *Smith* and *Doyle* cases, *supra.*

Appellant's Wife Is Either Taxable on Her Half of the Past Earnings of the Community or Upon the Property Which She Received in Exchange Therefor.

But, says the appellee, although appellant's wife owned half of said fees prior to the agreement and would have been taxable thereon had they been collected prior thereto, the tax burden is shifted from her to appellant because he and not his wife owned her half when the *receipt* of income took place (styled by appellant, the taxable event). (p. 11.)

Appellee cites *Anderson v. Com.*, 78 F. (2d) 636 (C. C. A. 9), and *Poe v. Seaborn*, 282 U. S. 101, as authority for this argument but neither case supports it. The *Anderson* case actually involved only the income from community property accumulated prior to 1927 by a California husband and wife and not past earnings of the marital community from the services of the spouses.

Prior to 1927 a California wife had only an expectancy and not a vested interest in community property. *U. S. v. Robbins,* 269 U. S. 315, 46 S. Ct. 148. Anderson and his wife made an oral agreement that they would own such property as tenants in common and not as community property. This Court merely held that the agreement was effective to make such property tenancy in common instead of community property and therefore the husband was not taxable on all but on only one-half of the income. This is shown by the closing sentence in the opinion of the Board (33 B. T. A. 94) on the remanded case, as follows:

> "Upon our amended findings of fact and in view of the opinion of the Circuit Court of Appeals, we are of the opinion that petitioner is liable to income tax upon only one-half of the *income from the properties* owned by petitioner and his wife during the year in question." (Emphasis supplied.)

Poe v. Seaborn is the original case which holds that where a wife has a vested interest in the marital community, earnings of both spouses are taxable one-half to each spouse. There was no assignment of either past or future earnings involved in that case. The court held that the earnings of a particular spouse are never his or hers so long as the community exists but are that of the community. In other words, the particular spouse does not earn the income, the marital partnership earns it.

On page 13 of its brief, appellee has misquoted appellant's position to be as follows:

> "The accrual of the right to income is the taxable event for a taxpayer reporting on the cash basis and since the earnings in question accrued as community income they must be taxed as such."

Actually appellant's position is that the owner of income at the time of accrual is the one who must ultimately pay income tax thereon regardless of whether or not he owns it when it is collected. The taxable event to a cash basis taxpayer is not the accrual but the collection (receipt), unless the original owner *has* sold or assigned the income for property or money in which event the *receipt of the consideration* is the taxable event.

If appellant has collected an amount in excess of the consideration which he paid his wife for her half interest such excess is taxable to him. To this extent his receipt or collection of her half of said fees is a "taxable event".

The "taxable event" to appellant's wife was her receipt of his half of certain property in exchange for her half of said fees. She was taxable at that instant upon the value of said property so received regardless of when, if at all, appellant collected her half of said fees. For instance in the *Smith* and *Doyle* cases, *supra,* the Court did not inquire when or whether the remaining partners collected the retiring partner's share of the fees which he conveyed to them. The taxable event to the retiring partner, who reported his income on a cash basis, was not the receipt or collection by the remaining partners of his share of the fees, but the receipt by him of the consideration paid to him for his share of said fees.

In the *Smith* case, the Court said:

> "Except for the 'purchase' and release, all his collections would have been income; the remaining partners would merely have turned over to him his existing interest in earnings already made. As he kept his books on a cash basis, it is true that he would have been taxed only as he received the accounts in

driblets, but he would have been taxed upon them as income. The 'purchase' of that future income did not turn it into capital, (not in his hands but it was capital in the hands of the acquiring partners) any more than the discount of a note received in consideration of personal services. (The note would be capital in the hands of the purchaser.) The commuted payment merely replaced the future income with cash. Indeed, this very situation was suggested in Bull v. United States, *supra,* 295 U. S. 247, at pages 256, 257, 55 S. Ct. 695, 698. 79 L. Ed. 1421, and dealt with as we say. Nobody would suggest that the sale of a declared dividend payable in the future turns the cash received into capital." (Parenthetical clauses supplied.)

In *Bull v. United States*, 295 U. S. 247, the Court considered a similar hypothetical situation in the following language:

> "* * * Let us suppose Bull had, while living, assigned his interest in the firm, with his partners' consent, to a third person for a valuable consideration, and in making return of income had valued or capitalized the right to profits which he had thus sold, had deducted such valuation from the consideration received, and returned the difference only as gain. We think the Commissioner would rightly have insisted that the entire amount received was income."

In *King v. Com.* (C. C. A. 5), 69 F. (2d) 639, a legal fee was earned by a marital community before it was dissolved by the death of the wife and the fee was collected after her death by the husband. The Commissioner claimed the husband was taxable on all the fee instead of his half. The Court held that the husband was taxable only on his half of the fee and the wife's estate was taxable on the other half because *she owned one-half of said fee at the time it was earned* by the marital community.

Let us suppose that in the present case appellant has surrendered or assigned his half of said fees to his wife and she had retained her half. Then such fees would have been her "separate property" when collected. Would the Government then say that the husband was relieved from tax on his half thereof? Of course not—but every argument the Government makes in this case would be equally applicable, except that she did not actually perform the service which is immaterial.

Or let us suppose that in the settlement appellant and his wife each retained their halves of the fees, and after the settlement the appellant exchanged a piece of his real estate or paid her money for her half. Then certainly under elementary income tax law she would have been taxable on the consideration received and appellant could recover the consideration paid by him before he realized any income. *Smith* and *Doyle* cases, *supra.* This is exactly what occurred in the property settlement except everything was accomplished in one transaction instead of two transactions as in this hypothetical example.

Appellant Is Entitled to Recover the Cost of the Property He Conveyed to His Wife in Exchange for Her Half of Said Fees.

1. Appellee next argues that appellant is not entitled to recover his cost of property transferred to his wife in exchange for or in lieu of her half of said fees, because the "Expenditures in connection with the dissolution of marriage constitute personal expenditures and as such are not deductible," (App. Br. p. 7.) With this general rule, taken from cases decided in separate property states. where the wife only has a right to alimony, appellant does not quarrel. However, in a community property state there are two classes of rights which must be settled:

(a) Any marital rights which either spouse has against the other, including the right, if any, to support by either a wife or a husband from the other, must be settled by agreement or by the Court.

(b) The community property of the spouses must be divided either by agreement or by the Court.

In this case the spouses settled both rights by agreement. They settled their marital rights, exclusive of dividing their community property, by the husband agreeing to pay his wife $6,000.00 at the rate of $500.00 per month [Finding VII, R. 53.] This was a "personal expenditure in connection with a dissolution of marriage" and appellant does not claim he is entitled to recover or offset it against the half of the fees acquired from his wife. Whatever a husband pays a wife in money or property, either at the time of settlement, or afterwards for her support or other marital rights (except property rights) is such a personal expenditure.

However, the transfer by appellant to his wife of his half of certain joint and community properties, was not for her release of any marital rights, but for half of said fees of $52,028.45 and her half of certain other property. As found by the lower court the $6,000.00 cash payment made by appellant "was in full satisfaction of and constituted a complete discharge of the rights, if any, which his wife had to receive support, maintenance and alimony." [R. 53.][1] Therefore the transfer to her of his half interest in said properties could only have been for her half of said fees and other property. Had the half interest in said properties transferred by appellant to his wife been disproportionate in value to the half interest in the fees and other property acquired by him from her, the difference might well have constituted a "personal expenditure" and not the cost of acquiring his wife's half of said fees and other property and the lower court would have so found.

Appellee cites only two cases in support of this point (other than those of this Court relating to "emancipation" of the spouses by agreement), *viz.*, *Gould v. Gould,* 245 U. S. 151, and *Ullman v. Commissioner,* 6 B. T. A. 100, 102. The *Gould* case involved the question of whether cash payments of alimony were taxable to the wife and deductible by the husband for income tax. The Court held the payments were not taxable to the wife and not deductible by the husband. Appellant does not claim a deduction for the alimony which he paid his wife.

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[1]There was considerable testimony below on this point but because Finding VII [R. 53] was correct, appellant did not have any part of the transcript printed covering the testimony thereon and appellee caused only part thereof to be printed. [R. 94, 95, 96, 97, 111, 112.]

The *Ullman* case also involves alimony paid in 1922 by a California husband to his wife. He deducted the payments for income tax purposes and the Board held he could not do so. Since it *was not until 1927* that a wife in California had a vested interest in the community earnings and prior to that time the husband was taxable on all of the community earnings, this case simply applies the rule announced in the *Gould* case, *supra*.

2. The appellee next argues that no capital transaction is involved and says that the property transferred by appellant to his wife was simply the cost of freeing his past earnings from a prospective claim of his wife, and was not the cost of acquiring a capital item having a cost basis (p. 25). Appellant has already shown that the past earnings were not his but those of the marital partnership and that regardless of the nature of the transaction his wife is either taxable on the consideration received therefor or her half of the fees themselves. He will now show that a capital transaction was involved.

The Capital Transaction Involved.

The lower court in this case stated in its opinion in part as follows:

> "But here, the accounts receivable were original income and a capital transaction was not involved."

As set forth in appellee's brief the Board of Tax Appeals stated in a similar case (on authority of the lower court's opinion in this case), *Crosby v. Commissioner*, 46 B. T. A. 323, 331:

> "The right received by the petitioner (taxpayer) was one to receive ordinary earnings, and not property acquired through capital expenditures."[1]

Many taxpayers and even the Commissioner of Internal Revenue often become confused as to a capital transaction when original income is involved. For examples see the quoted portions of the *Smith* and *Bull* cases on pages 11-12. Prior to the property settlement the wife's community half of the fees involved unquestionably was "original income" or "the right to receive original earnings" and remained such until or unless a "taxable event" transposed it into capital. Until "original income" becomes "realized" by collection or by assignment for a full consideration in money or property it does not become capital. *Mesta*. *Smith* and *Bull* cases, *supra*.

Appellee agrees with this rule on page 27 of his brief in the following language:

> "Earnings must be taxed as income before they attain the status of capital" but says appellee, "to allow the taxpayer (appellant) a cost basis for any portion of his earnings would permit the conversion of taxable income to capital without assessment of an income tax."

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[1]In the *Crosby* case the payments made by the husband were called alimony in the property settlement and were so held by the Board, although the husband claimed they were actually paid for his wife's one-half of certain "past earnings." If the payments were actually alimony then of course they were not the cost of acquiring his wife's half of "past earnings" of the marital community. In effect the Board in the *Crosby* case reiterates the erroneous position which it took in *Bigelow v. Commissioner*, 38 B. T. A. 377, which case it afterwards reconsidered, reversed and corrected in 39 B. T. A. 635, after this Court rejected such principle in the *Goodyear* case, *supra*.

If the wife were not taxable on her half of said fees, or upon the consideration she received from appellant, this argument might be persuasive, but since she is so taxable thereon *her half is thus converted into a capital asset in appellant's hands* and has a cost equivalent to the cost of the property exchanged therefor. Her half of said fees were never capital in her hands. The receipt by her of appellant's half of other property in exchange therefor was the "taxable event" which transposed her half into a capital asset in appellant's hands. The half interest of the properties acquired by her from appellant was then a capital asset in her hands. She was taxable on the market value thereof and such value then became her cost or basis, for determining gain or loss on the subsequent disposition of the half interest acquired by her.

The wife's half of said fees became a capital asset in appellant's hands because he exchanged his half of other property therefor. When he collected her half of said fees he realized gain or loss based upon the difference between his cost of the property exchanged and the value of her half of said fees acquired by him.

The discussion of the *Mesta* case, *supra,* on page 26 of appellee's brief, is confusing. For instance appellee says "It is not suggested by the opinion in that case that the transfer gave the taxpayer a cost basis for the stock." In the *Mesta* case the transferror of the stock was the taxpayer (husband) and not the transferee (wife). Here the transferee is the taxpayer (husband) and not the transferror (wife). Appellant does not claim that the transfer gave any cost to his wife (transferror) for her half of the fees transferred. He admits that, since she "disposed" of her half of said fees, she was taxable *in full* on either her half of the fees or upon the consideration received because she had no cost. The court in the *Mesta* case did not consider nor decide what cost or basis the wife (transferee) had for determining the gain or loss upon her subsequent sale or disposition of the stock acquired by her from her husband, but it is obvious that it would be the market value thereof at the time she acquired it from Mesta. Likewise in this case appellant's cost or basis for determining gain or loss on his subsequent disposition (collection) of his wife's half of said fees was the market value of them when acquired by him.

On page 21 of its brief appellee argues that in the *Somerville* case, 123 F. (2d) 650, it could have been plausibly contended that his agreement to pay and payment to his wife of half of his future earnings for two years represented his cost of acquiring her half interest in his future earnings and therefore he was entitled to offset them against his future earnings for income tax purposes. The answer to this is that the wife's community right to half of the husband's earnings exists only so long as the marital community exists. She has no right to half of the husband's earnings after the community is dissolved by divorce, death or agreement. It would be just as logical to argue that when a two-man law partnership is dissolved one partner would have a right to a half share of the future earnings of the other partner.

3. Finally appellee argues that appellant already owned his wife's one-half of said fees, or had control and management thereof equivalent to ownership, so that he acquired nothing of value from his wife in the settlement when he "technically" acquired her half of said fees.

It suffices to say that this is exactly the same argument made by the Government in such cases as *Poe v. Seaborn, supra; U. S. v. Goodyear* (C. C. A. 9), 99 F. (2d) 523, and the many other cases where the Government contended that the husband in all community property states is taxable on all community income, and that all of the community property is taxable for Federal Estate Tax purposes in the estate of the husband. In all of these cases it was held that the wife had equal ownership with the husband, and that his management and control was merely as agent for the community and not for his own benefit.

However, even the husband's control or management *as agent* disappears when a divorce is imminent. The power of the husband to manage and control the community property terminates on dissolution of the marriage by divorce, 31 *C. J.* 181; *Barkley v. American Sav. Bank, etc. Co.*, 61 Wash. 415, 112 P. 495; *La Tourette v. La Tourette*, 15 Ariz. 200, 137 P. 426. The right which the wife has in California, and frequently exercises, to restrain a husband from disposing of or spending any community funds pending the decision of a divorce action effectively protects her when a divorce is in prospect. *California Code of Civil Procedure*, Sec. 526; *Sun Insurance Co. v. White*, 123 Cal. 196; *In re White*, 113 Cal. 282; *White v. Superior Court*, 110 Cal. 54.

Conclusion.

The decision of the District Court is erroneous and should be reversed.

Respectfully submitted,

Todd W. Johnson,

In Propria Persona.